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Veteran tweaks Graham's rule to find bargains

Marty Whitman finding best value in 50-year career

Levi Folk, Financial Post

Security Analysis, the original book on value investing by Benjamin Graham and David Dodd, published in 1934, was inspired by the market crash of 1929. The book said investors were on solid ground if they owned shares in "net-nets" --companies whose liquidation values exceed by a wide margin their market capitalizations net of all liabilities.Net-nets were a proven strategy for protecting capital and achieving long-term gains.

Marty Whitman, chairman of Third Avenue Management and manager of the Third Avenue Value Fund, is the closest thing we have to Benjamin Graham today. Coming off an uncharacteristically difficult year, Whitman is finding bigger discounts in the market than at any time in his 50-plus year career.

A vociferous critic of Generally Accepted Accounting Principles (GAAP),Whitman makes refinements to the Graham and Dodd concept of net-net.

First and foremost, companies must be well-financed in keeping with the core tenet of Third Avenue's "safe and cheap" method of value investing.

The goal is to own companies that are going concerns, not ones destined for liquidation. This difference is a crucial point of distinction between the focus of equity investors, who are often wiped out in liquidation, and bond investors, who have rights to the assets of a company in liquidation.

The second adjustment is to the assets themselves. Graham and Dodd focused exclusively on current assets when calculating liquidation value whereas Whitman includes long-term assets that are easily liquidated.

For example, roughly one third of long-term assets of Toyota Industries Corp. are investment securities, including a 6% position in Toyota Motor Corp. (TM/TSX), says Ian Lapey, portfolio manager at Third Avenue and designated successor to Whitman on the Third Avenue Value Fund.

These securities are therefore included in Third Avenue's calculations of net-net.

Closer to home, oil and gas producer Encana Corp. (ECA/ TSX) has proved reserves of oil and natural gas that are not included in current assets, says Lapey.

"They are liquid in that there is a real market, current commodity prices notwithstanding, for high-quality proved reserves of oil and gas." Encana is a top holding in AIC Global Focused Fund, sub-advised by Third Avenue and managed by Lapey.

The third adjustment is the inclusion of off-balance-sheet liabilities. Here, U. S. banks' structured investment vehicles readily spring to mind.

The fourth and final adjustment to Graham and Dodd is the inclusion of "some property, plant and equipment" for their liquidated cash value and associated tax losses that often produce cash savings.

Hong Kong real estate companies, such as top holding Henderson Land Development Co. Ltd. (0012/HK),are required to mark property values to market prices, so liquidation values are easily ascertained.

"In most time periods, the market for fully leased office buildings is quite liquid," says Lapey, justifying their inclusion in net-net calculations of these companies.

Sycamore Networks Inc. (SCMR/NASDAQ) is the most compelling example of a net-net situation in the United States offered up by Lapey.

The telecom equipment company has more cash -- US$935-million in all -- than the total value assessed to it by the market, in light of its US$800-million market capitalization and US$38-million in total liabilities.

"We feel that there is value to their technology that is being recognized by some of the large telecom carriers," says Lapey of Sycamore Networks, but he acknowledges its current weak earnings power. Lapey is also attracted to the one-third of outstanding share ownership by management because it presents an important alignment of their interests with those of Third Avenue, who are by and large passive investors.

These large valuation discounts in the market are reassuring words for investors from the one of the finest practitioners of Graham and Dodd.

"We are holding these companies trading at huge discounts," says Lapey, "and if these companies were to sell assets or sell the whole companies we think the result would be a terrific return for our investment."